IT 05-0039-GIL 08/08/2005 ALTERNATIVE APPORTIONMENT

General Information Letter: Petition for alternative apportionment cannot be granted based on facts shown in the petition.

August 8, 2005

Dear:

This is in response to your letter dated April 5, 2004, in which you request permission to use an equally-weighted three-factor apportionment formula as provided in Section 304(a) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 101 *et seq.*) as originally enacted, rather than the "single sales factor" apportionment formula currently mandated in Section 304(a) of the IITA, pursuant to the Director's authority granted by Section 304(f) of the IITA. I apologize for the delay in responding. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us. For the reasons discussed below, your petition cannot be granted at this time.

In your letter you have stated the following:

> We are making this petition on behalf of our client COMPANY, Inc. ("COMPANY") – Federal ID XX-XXXXXXX. We have attached a Power of Attorney granted by our client. On behalf of our client, we are requesting permission to use alternative apportionment to determine income apportionable to Illinois, as provided in IITA Section 304(f) and implemented through 86 Ill. Adm. Code 100.3390.
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> We are petitioning for an alternative apportionment formula for the tax year ended April 30, 2003, and all subsequent years. Pursuant to Section 100.3390(e) of the rules of the Illinois Department of Revenue ("the Department"), COMPANY recently timely filed an Illinois Income Tax return for the tax year ended April 30, 2003 ("the 2003 tax year") using the statutory apportionment formula. In conformance with Section 100.3390(e)(2) of the Department's rules, this petition was filed as an attachment to a return amending the original return that was filed using the statutory apportionment formula.
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> ?? **FACTS and ANALYSIS**
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> COMPANY is a wholesaler of tobacco products with offices, property, and personnel in the state of New Jersey. Besides New Jersey, COMPANY employs one sales person in Florida. Additionally, during the fiscal year ended April 03 covered by the tax return in question, COMPANY rented warehouse space in the State of Illinois to facilitate distribution of their products to states in the region.
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> COMPANY does not employ any persons, nor does it hold any other property besides inventory in the warehouse, in the state of Illinois. The warehouse space rented in Illinois is a third party warehouse with no other connection to COMPANY. The warehouse in Illinois ships products, as instructed, to various locations in the region. COMPANY has no other activity in the State of Illinois.

COMPANY had total sales of $24,405,698 during the 2003 tax year. Sales to customers located in Illinois were $180,731, a mere **0.74**% of total sales. All of the sales made by COMPANY were accepted and approved from the location in New Jersey. During the fiscal year ended April 30, 03, the Illinois warehouse shipped goods amounting to sales of $15,884,304 to states outside of Illinois. The detail breakdown is as follows:

Alabama	$2,308,439
Arkansas	396,206
California	1,078,337
Georgia	1,591,524
Iowa	876,461
Idaho	1,292,832
Kansas	36,519
Kentucky	1,210,789
Louisiana	2,468,852
Missouri	860,221
Mississippi	357,952
Montana	1,169,299
New York	70,064
Ohio	508,942
Oklahoma	222,968
Oregon	30,343
Pennsylvania	15,630
South Dakota	62,862
Tennessee	707,968
Texas	569,901
Wisconsin	47,036
West Virginia	1,158
Total	**$15,884,304**

Section 304 of the Illinois Income Tax Act sets forth the manner in which the business income of a multistate corporation is to be apportioned to Illinois. (35 ILCS 5/304) For the 2003 tax year, COMPANY was required, under the normal Illinois single factor sales apportionment formula, to compare sales in Illinois to sales everywhere. Section 100.3370 of the rules of the IDOR sets forth rules governing the sales factor. Section 100.3370(b) provides that the denominator of the sales factor "shall include the total gross receipts derived by the person from transactions and activity in the regular course of its trade or business, except receipts excluded under 86 Ill. Adm. Code 100.3380(b)." Section 100.3370(c) provides that the numerator of the sales factor includes "the gross receipts attributable to this State and derived by the person from transactions and activity in the regular course of its trade or business." Subsection 100.3370(c)(1)(F), commonly referred to as the "throwback rule," states that "if the person is not taxable in the state of the purchaser, the sale is attributed to this State if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State." Of the goods shipped from the Illinois warehouse, $14,735.903

in sales are to be thrown back to Illinois under the throwback rule, resulting in a single sales factor apportionment of 61.1195% to Illinois.

Section 100.3390(c) of the IDOR rules sets forth the burden of proof for petitions for alternative allocation or apportionment. Section 100.3390(c) provides that "if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair and accurate alternative method is appropriate." The Department's rule also provides at Section 100.3390(c) that "the party seeking to utilize an alternative apportionment method has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income that is out of all proportion to the business transacted in the State".

The manner in which the business income of a multistate corporation is to be apportioned to New Jersey is set forth by NJ Sec. 54:10A-6 as follows:

"In the case of a taxpayer which maintains a regular place of business outside this State other than a statutory office, the portion of its entire net worth to be used as a measure of the tax imposed by subsection (a) of section 5 of P.L. 1945, c. 162 (C.54:10A-5), and the portion of its entire net income to be used as a measure of the tax imposed by subsection (c) of Section 5 of P.L. 1945, c. 162 (C.54:10A-5), shall be determined by multiplying such entire net worth and entire net income, respectively, by an allocation factor which is the property fraction, plus twice the sales fraction plus the payroll fraction and the denominator of which is four, except as the director may determine pursuant to section 8 of P.L. 1945, c. 162 (C.54:10A-8) . . .

. . . In the case of a taxpayer which does not maintain a regular place of business outside this State other than a statutory office, the allocation factor shall be 100%."

New Jersey Regulation Reg. 18:7-7.2 defines regular place of business as follows:

"(a) A regular place of business is any bona fide office (other than a statutory office), factory, warehouse, or other space of the taxpayer which is regularly maintained, occupied and used by the taxpayer in carrying on its business and in which one or more regular employees are in attendance. The following will assist in the determination of what is a regular place of business.

1. Bona fide office: An office in which an employee in attendance performs significant duties related to the business of the employer. A token office space of the taxpayer or any place where an employee does not actually perform significant duties constituting part of the taxpayer's business does not constitute a regular place of business.

2. Space of the taxpayer: The taxpayer must be directly responsible for the expenses incurred in maintaining the regular place of business and must

> either own or rent the facility in its own name and not through a related person or entity. The regular place of business should be identifiable as belonging to the taxpayer by, for example, reflecting the taxpayer's name on the exterior and interior of the building and being listed in the taxpayer's name in a telephone book . . ."

Further, the above regulation, in pertinent part, specifically states that:

"i. The facilities of a public warehouse located outside New Jersey and utilized to store property of the taxpayer prior to shipment to customers shall not constitute a regular place of business of the taxpayer where the warehouse is not the space of the taxpayer."

The overwhelming majority of COMPANY's activities take place in New Jersey.

COMPANY does not have any regular place of business outside of New Jersey. COMPANY, therefore, apportions 100% of its income to New Jersey. Besides New Jersey, and Illinois for the fiscal year in question, COMPANY also had nexus and filed returns in three additional states and paid taxes based on income as follows:

States	Apportionment
California	4.2687%
New York	4.8986%
Florida	3.8640%
Total	**13.0313%**

Copies of the tax returns for the above states are enclosed herewith.

Corporations that have to apportion 100% of the income to New Jersey, based on the above rules, are entitled to an adjustment in the form of a credit for taxes paid to New Jersey under N.J.S.A. Sec. 54:10A-8. The manner in which this adjustment is to be worked out is provided in pertinent part of N.J.A.C. Sec. 18:7-8.3. as follows:

". . . b) Reduction in tax for income duplicated on a return filed with another State pursuant to N.J.S.A. 54:10A-8 and this rule – 100 percent allocation factor:

1. Eligibility:

i. Where the Business Allocation Factor under Section 6 of the Act is 100 percent and the taxpayer in fact paid a tax based on or measured by income to a foreign state, resulting in a duplication of income being taxed, it may, under Section 8 of the Act, apply for a reduction in the amount of its tax. The reduction is available only where the taxpayer in its own right acquired a taxable status in the foreign state by reference to at lease one of the criteria described at N.J.A.C. 18:17-1.6 as if the New Jersey Corporation Business Tax Act were the law of that foreign state . . .

. . . Any duplication of income being reported to New Jersey and to State X may not form the basis for a reduction in tax.

2. Method:

i. An eligible taxpayer computes its reduction on a rider attached to its return by demonstrating that part of entire net income is duplicated on a return filed with another state. It must attach a copy of all relevant portions of the return filed with the foreign state relating to income reported, the computation of all components of its apportionment fractions and the computation of the tax paid to the foreign state. It must also submit a schedule apportioning all property, receipts and payroll to a common denominator defined consistent with the return. For purposes of calculating the reduction:

(1) It may be based upon only so much of adjusted entire net income appearing on its Corporation Business Tax Return as is reported to the foreign state;

(2) The formula apportionment used in the foreign state may not exceed the Business Allocation Factor as determined under Section 6 of the Act and these rules;

(3) It must be computed by using the lesser of the tax rates of the foreign state or the tax rate under the New Jersey Corporation Business Tax Act."

Since New Jersey uses a three-factor formula, and does not have an equivalent of the throwback rule that Illinois has, the credit computed, for taxes paid to Illinois is limited to the tax liability computed using New Jersey apportionment rules. This results in a credit of about $46,399 compared to Illinois tax liability of $270,680.

The credit adjustment, based on the above rules, therefore does not counter balance the tax burden imposed by apportioning income out of proportion to the State of Illinois.

In this instance, an apportionment percentage of 61.1195% does not accurately or fairly represent the extent of taxpayer's activity in the State of Illinois. As explained above, the activities of COMPANY in the State of Illinois are limited to the rental of space in a third party warehouse. However, the operation of the single sales apportionment factor and the Illinois throwback rule result the attribution of income to Illinois in an amount that is out of all proportion to the level of activities of COMPANY in Illinois. This result leads to a gross distortion of income taxable in Illinois. That gross distortion exists is made evident by the fact that COMPANY would be subject to the same apportionment if they were 100% located in Illinois, and conducted all their activities in Illinois. The statutory level of apportionment results in taxing value earned outside the state and violates both the due process and the commerce clauses. We respectfully submit that since all of COMANY's activities are performed in New Jersey, apportioning 61.1195% of income to Illinois is unreasonable, and arbitrarily attributes a percentage of income tat is out of all proportion to the level of activity that takes place in Illinois. We

respectfully submit that the foregoing discussion clearly indicates, consistent with the requirements of Section 100.3390(c) of the Department's rules that the operation of the statutory formula "results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State." Based on the above, COMPANY will be subject to tax on 174.1508% of their income resulting in double taxation. Even with the credit adjustment for New Jersey, as explained earlier, COMPANY will be still subject to 150.2305% of its income. Therefore as provided in IITA Section 304(f) and Section 100.3390, we request that COMPANY be granted relief and allowed to use an alternative method of apportioning income to Illinois that "fairly and accurately apportions income to Illinois based upon business activity in this State."

We propose that the taxpayer be allowed to use the equally weighted three-factor formula that will take into account not only the sales, but also the property and payroll factors. The attached amended return sets forth the operation of this alternative formula. The alternative formula, consistent with the requirement of Section 100.3390(c) of the IDOR rules allows for a fair and accurate consideration of all business activity performed in Illinois versus that activity performed outside the state. Based on an average inventory of $1,072,294, held in the state throughout the fiscal year, and keeping the sales factor as the same, the three-factor formula will result in an apportionment of about 33.13%. This will result in a tax liability of $133,159 compared to the tax liability computed under the statutory one-factor formula of $244,579. (Note: The liability on the original return was computed at $270,680 due to an error on Line 2a of the original return. Total of income taxes paid to all the states was erroneously taken as an addition, on line 2a, rather than just taking income and replacement taxes paid to Illinois on line 2b. The amended return reflects this correction). We would submit that, while Section 100.3390(c) of the IDOR rules provides that this deviation of 83.65% between the statutory formula and the alternative formula we have proposed is not the basis for approval of the formula merely because the alternative formula reaches a different result, the evidence that clearly indicates that the statutory one-factor formula results in a level of taxation out of all proportion to the level of activity of COMPANY in Illinois that grossly distorts the level of income attributable to Illinois.

We submit that alternative apportionment based on the equally-weighted three-factor formula will, in this instance, result in overall state taxation of COMPANY's income that will satisfy the "internal consistency test" developed by the US Supreme Court to be in conformity with the commerce clause.

Based on the above facts, we request that COMPANY be granted permission to use the alternative apportionment in determining income taxable in the state of Illinois.

Response

Section 304(f) of the IITA provides:

If the allocation and apportionment provisions of subsections (a) through (e) and of

> subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
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> (1) Separate accounting;
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> (2) The exclusion of any one or more factors;
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> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
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> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Taxpayers who wish to use an alternative method of apportionment under this provision are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390, which may be found on the Department's web site at www.revenue.state.il.us.

86 Ill. Adm. Code Section 100.3390(c) provides:

> An alternative apportionment method may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula.

Your petition contains an exposition of the income apportioned to Illinois under Section 304(a) of the IITA and the income allocated to New Jersey under its radically different laws, and a claim that, because the effect of the two very different laws is to tax COMPANY on more than 100% of its income, the Illinois apportionment rule must be distortive. Moreover, your petition contains no analysis showing why the requested alternative apportionment formula is superior to the statutory formula, other than to show that using it would reduce the amount of double-taxed income. Your petition is, therefore, nothing more than a showing that the requested alternative formula reaches a different result. Accordingly, your petition cannot be granted at this time.

Incidentally, the property factor computed on your amended return is based solely on inventory, as reported on Schedule L of your federal Form 1120. A proper computation of the property factor would include all real and tangible personal property owned or rented by COMPANY and used in its business. See Section 304(a)(1) of the IITA.

This letter is not a protestable denial of your refund claim. At this time, you may respond to this letter by presenting to me additional materials and arguments in support of your petition or you may request a formal denial of your claim so that you may protest the denial and request a hearing as provided in 86 Ill. Adm. Code Section 100.3390(h).

Please note that 86 Ill. Adm. Code Section 100.3390(e)(1) requires a petition to be filed at least 120 days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment method. In the alternative, 86 Ill. Adm. Code Section

100.3390(e)(2) allows the petition to be filed along with an amended return showing the results of using the proposed formula in the taxable year for which it is requested. Your petition was attached to an amended return for the taxable year ended April 30, 2003, filed April 5, 2004, and so granting the petition will allow COMPANY, Inc. to use the requested method on its return for the taxable year ended April 30, 2003, and on returns due on or after August 3, 2004.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you still believe that your petition should be granted, please supplement the petition in accordance with the provisions of 86 Ill. Adm. Code Section 100.3390. If you have any questions, you may contact me at (217) 524-3951.

Sincerely,

Paul S. Caselton
Deputy General Counsel -- Income Tax